

# CREATING INSECURITY: THE INTERPRETATION OF INSECURITY CLAUSES TRIGGERED BY REAPPRAISALS ORDERED BY COMMERCIAL MORTGAGE LENDERS

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## INTRODUCTION

Imagine a nice restaurant in a flourishing commercial area of your city. A few years ago, the owner of this restaurant obtained financing from a commercial mortgage lender to open the restaurant.<sup>1</sup> The restaurant, like the part of town where it is located, is thriving. During the economic downturn faced by the majority of the United States,<sup>2</sup> the neighborhood where the restaurant is located fared better than many other parts of the country.<sup>3</sup> In this area, people are still eating out regularly, visiting the nearby high-end mall, and spending money freely. There is no indication that this area is experiencing as severe of a downturn as most of the rest of the country is experiencing. Because of the restaurant's success, the owner has had no trouble making his regular required loan payments to the lender. The owner also always ensures that his payments are on time.<sup>4</sup> Since opening in 2005, the owner has not made any substantial changes to the property, and there has been no deterioration beyond normal wear and tear.<sup>5</sup>

The structure of the commercial mortgage provides the lender with a second avenue of collection.<sup>6</sup> If the owner fails to make a loan payment,

1. See generally CONG. OVERSIGHT PANEL, 111TH CONG., FEB. OVERSIGHT REP., COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 13 (2010), available at <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT54785/pdf/CPRT-111JPRT54785.pdf> (explaining how commercial mortgages act as financing for businesses). Throughout the rest of this Note, commercial mortgage will refer to a recourse commercial mortgage loan, and lender will refer to a commercial mortgage lender. A recourse loan is "[a] loan that allows the lender, if the borrower defaults, not only to attach the collateral but also to seek judgment against the borrower's (or guarantor's) personal assets." BLACK'S LAW DICTIONARY 1021 (9th ed. 2009).

2. See generally Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. ECON. PERSP. 77, 77-78 (2009) (explaining how the downturn began in 2007).

3. See, e.g., John Collins Rudolf, *Phoenix Meets the Wrong End of the Boom Cycle*, N.Y. TIMES, Mar. 17, 2010, at B6, available at [http://www.nytimes.com/2010/03/17/realestate/commercial/17phoenix.html?pagewanted=1&\\_r=3&sq=commercial%20foreclosure&st=cse&scp=10](http://www.nytimes.com/2010/03/17/realestate/commercial/17phoenix.html?pagewanted=1&_r=3&sq=commercial%20foreclosure&st=cse&scp=10) ("Desirable pockets in affluent cities like Scottsdale have little vacant space available at any price, while areas close to the downtown core and along established urban corridors are weathering the storm fairly well.").

4. A loan payment is considered timely when it is made on or before the due date.

5. As defined by *Black's Law Dictionary*, wear and tear means "[d]eterioration caused by ordinary use." BLACK'S LAW DICTIONARY, *supra* note 1, at 1731.

6. A lender is "[a] person or entity from which something (esp. money) is borrowed." *Id.* at 985. A secured creditor is "[a] creditor who has the right, on the debtor's default, to proceed against collateral and apply it to the payment of the debt." *Id.* at 425. By

then the lender can foreclose on the restaurant and sell it to collect the money it is due.<sup>7</sup> This commercial mortgage also contains a standard insecurity clause.<sup>8</sup> An insecurity clause allows the lender to demand payment or to foreclose if the lender feels insecure about receiving repayment from the borrower.<sup>9</sup> Despite the success of the neighborhood and the restaurant, the lender who financed the owner's loan decided to have the restaurant reappraised.<sup>10</sup> The lender hired an appraiser to determine the restaurant's current value.<sup>11</sup> The appraiser looked at comparable properties in the area and evaluated possible sale prices for the property.<sup>12</sup> Determining an accurate value for the restaurant is challenging because there have not been many sales in the area due to the economic downturn, and the properties that have sold were generally distressed sales.<sup>13</sup> The appraiser found that the restaurant's appraised value had significantly decreased from the property's appraised value at the origination of the loan.

The owner has been making payments towards the loan for a number of years, so only about half of the total loan is still outstanding. The property's appraised value, although less than the original appraised value, is still higher than the outstanding balance due on the loan. Given these circumstances, the lender determined that it is insecure about being made whole. The lender informed the owner that he must pay the outstanding balance of the loan in full now, even though the original maturity date provided in the note is several years away.<sup>14</sup> The owner will probably not be able to come

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contracting for a second avenue of collection, the lender becomes a secured creditor. A secured loan is "[a] loan that is secured by property or securities." *Id.* at 1021.

7. A commercial mortgage is "[a] mortgage loan written for a business purpose with a building used as collateral." *Small Business Glossary of Terms*, TD BANK, [http://www.tdbank.com/bank/glossary\\_sb.html](http://www.tdbank.com/bank/glossary_sb.html) (last visited Apr. 19, 2012). A foreclosure is "[a] legal proceeding to terminate a mortgagor's interest in property, instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the property." BLACK'S LAW DICTIONARY, *supra* note 1, at 719.

8. As defined in *Black's Law Dictionary*, an insecurity clause is "[a] loan-agreement provision that allows the creditor to demand immediate and full payment of the loan balance if the creditor has reason to believe that the debtor is about to default." BLACK'S LAW DICTIONARY, *supra* note 1, at 866. For the purpose of this Article, an insecurity clause is a type of acceleration clause.

9. *Id.*

10. An appraisal is "[t]he determination of what constitutes a fair price" and "[t]he report of such a determination." *Id.* at 117.

11. An appraiser is "[a]n impartial person who estimates the value of something, such as real estate." *Id.*

12. See generally *The Real Estate Appraisal Process*, SHENEHON CO., [http://www.shenehon.com/index.cfm/the\\_real\\_estate\\_appraisal\\_process/40](http://www.shenehon.com/index.cfm/the_real_estate_appraisal_process/40) (last visited Apr. 19, 2012) (explaining different approaches to valuation).

13. See Eric Billingsley, *Brokers, Lenders, Appraisers Spar over Property Values*, SAN FERN. V. BUS. J., Feb. 1, 2010, at 4, available at <http://www.sfvbj.com/news/2010/jan/31/brokers-lenders-appraisers-spar-over-property-valu/>.

14. See *supra* note 8.

up with the full outstanding balance of the loan at this time. If he cannot pay, then the lender will foreclose on the property.<sup>15</sup> The lender is contractually able to do this because of the insecurity clause in the loan agreement.<sup>16</sup> However, the owner is making his payments on the loan, and the property's appraised value is greater than the value of the loan outstanding. Therefore, the issue is whether the lender is actually insecure. In this type of situation, the courts should protect borrowers from lenders' abuse of such clauses by requiring good faith in application of an insecurity clause and not allowing the lender to call the loan or foreclose on the secured property based on insecurity.<sup>17</sup> If the borrower has not violated any material covenants of the loan and the appraised value of the collateral is greater than the outstanding balance on the loan, then absent other evidence, the court should hold that a lender breached an implied duty of good faith in its use of the insecurity clause.<sup>18</sup>

This Note proposes a standard for courts to use when evaluating whether lenders have breached an implied duty to act in good faith when using an insecurity clause. Part I of this Note explains the role of good faith and insecurity clauses in the commercial mortgage industry and outlines the current environment of commercial mortgage lending. Part II focuses on the national approach and the varying state approaches that courts have taken when faced with the issue of good faith and acceleration clauses. Part III proposes a uniform standard by which courts can evaluate the actions of lenders that deem themselves insecure despite no contractual breach by the borrower and an appraised value that is greater than the outstanding balance due on the loan.

## I. CURRENT STATE OF COMMERCIAL MORTGAGE LENDING

Since December 2007, the United States has been experiencing an economic downturn.<sup>19</sup> This downturn affected the value of commercial real estate properties around the country, causing most of them to decrease significantly in value.<sup>20</sup> In response to the recession, many lenders have chosen

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15. See *supra* note 6.

16. The insecurity clause allows the lender to demand payment in full when it feels insecure. See *supra* note 8. This type of loan allows the lender to get that payment through foreclosing on the property, if needed. See *supra* note 6.

17. To call is "[t]o demand payment of money." BLACK'S LAW DICTIONARY, *supra* note 1, at 232.

18. See discussion *infra* Part III.

19. NAT'L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY 1 (2008), available at <http://www.nber.org/dec2008.pdf> [hereinafter ECONOMIC ACTIVITY].

20. Carrick Mollenkamp & Lingling Wei, *To Fix Sour Property Deals, Lenders 'Extend and Pretend,'* WALL ST. J., July 7, 2010, <http://online.wsj.com/article/SB10001>

to change the terms of their commercial mortgages or to extend them, rather than foreclosing on their properties.<sup>21</sup> Other lenders have chosen to foreclose based on insecurity, which in turn will increase their liquidity.<sup>22</sup> How lenders have responded to the decline has had a substantial effect on borrowers.

Commercial mortgages are a common mode of providing capital to businesses.<sup>23</sup> Lenders use these mortgages because they provide a second avenue of collection if a borrower defaults.<sup>24</sup> If the borrower defaults, the lender can foreclose on the secured property and sell it to recoup the remainder of the loan.<sup>25</sup> These loans typically have a lower interest rate and a low level of default risk because borrowers do not want to lose their property.<sup>26</sup> Despite the low level of default risk, lenders may still want more protection from default, so they include an insecurity clause in the loan agreement.<sup>27</sup> This clause allows a lender to request full payment before the date of maturity if the lender feels insecure about receiving full repayment of the loan.<sup>28</sup>

#### A. The Use of Insecurity Clauses in Commercial Mortgage Lending

In commercial mortgage lending, a borrower contracts with a lender for a loan to fund its business.<sup>29</sup> The lender protects itself by making the

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424052748704764404575286882690834088.html. "U.S. commercial-real-estate values remain 42% below their October 2007 peak." *Id.*

21. *Id.*

22. Liquidity is "[t]he quality or state of being readily convertible to cash." BLACK'S LAW DICTIONARY, *supra* note 1, at 1015.

23. "Commercial mortgages are those that have been secured by property owned or occupied by business enterprises . . ." Yuliya Demyanyk & Kent Cherny, *Bank Exposure to Commercial Real Estate*, FED. RESERVE BANK OF CLEVELAND (Aug. 11, 2009), <http://www.clevelandfed.org/Research/trends/2009/0809/01banfin.cfm>. "The total volume of commercial mortgages held by banks more than tripled in the last decade both nationally and in the Fourth District." *Id.* "Nationally, the volume at commercial banks peaked at approximately \$1.8 trillion last year." *Id.*

24. *See supra* notes 6, 7 and accompanying text.

25. *See supra* note 7.

26. *Commercial Property Loans*, SMALL BUS. FIN. TIPS, <http://www.smallbusinessfinancetips.com/commercial-property-loans.html> (last visited Apr. 19, 2012).

27. *See* John Pierre & M.R. Franks, *The Consequence of Default to the Debtor Under Part 5, Chapter 9 of the Louisiana Commercial Laws: A Primer on Debtor's Rights*, 18 S.U. L. REV. 21, 22 (1991) ("Most security agreements provide the secured party the option to accelerate the debt's maturity and to cause all payments to become due and payable immediately when the debtor has defaulted.").

28. U.C.C. § 1-309 (2004) (stating that an option to accelerate at will is "[a] term providing that one party . . . may accelerate payment . . . when the party 'deems itself insecure,' . . . means that the party has power to do so only if that party in good faith believes that the prospect of payment or performance is impaired").

29. As defined by *Black's Law Dictionary*, a borrower is "[a] person or entity to whom money or something else is lent." BLACK'S LAW DICTIONARY, *supra* note 1, at 209. A

borrower's property available as another means of collection if the borrower fails to pay.<sup>30</sup> The borrower's obligation is to make regular payments on the loan.<sup>31</sup> If the borrower misses a payment, the lender can collect on only the missed payment pursuant to the terms of the loan agreement.<sup>32</sup> To protect lenders against this delay in collection, most commercial mortgages include an acceleration clause in the agreement.<sup>33</sup> An acceleration clause allows the lender to sue for the total outstanding balance due as soon as the borrower misses the first payment or defaults in another way.<sup>34</sup> With an acceleration clause in the agreement, the lender can call the loan or foreclose on the property if the borrower stops making payments or defaults in some other manner that is outlined in the commercial mortgage.<sup>35</sup>

A variation of the acceleration clause is an insecurity clause.<sup>36</sup> Insecurity clauses are often tied to the value of the property that the borrower used to secure its loan.<sup>37</sup> If the value of the property decreases, the lender may no longer consider the property a sufficient "secondary source of repayment" and could request repayment of the entire loan.<sup>38</sup> Technically, the lender can request this repayment any time that it feels insecure about being made whole, even if the borrower has been making timely, regular payments.<sup>39</sup> Although the purpose of an insecurity clause is to protect the lender from nonpayment, there should be some limitations to the depth of that protection.<sup>40</sup> If a borrower is regularly making payments and shows no other indication of being unable to repay the loan in the future, then the lender should not penalize the borrower for situations where there is an overall decline in the market.<sup>41</sup> The concern is whether the institution is actually insecure un-

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loan is "[a]n act of lending; a grant of something for temporary use." *Id.* at 1019; *see supra* note 1.

30. *See supra* notes 6, 7 and accompanying text.

31. *See generally* *Wilcox v. Ex'rs of Plummer*, 29 U.S. 172, 179 (1830) ("If one borrows money, it is his duty to pay . . .").

32. *See generally* 10 C.J.S. *Bills and Notes* § 126 (2012).

33. An acceleration clause is "[a] loan-agreement provision that requires the debtor to pay off the balance sooner than the due date if some specified event occurs, such as failure to pay an installment or to maintain insurance." BLACK'S LAW DICTIONARY, *supra* note 1, at 12-13.

34. *See id.*

35. *See id.*

36. An insecurity clause is a type of acceleration clause. *Pierre & Franks*, *supra* note 27, at 22.

37. *See supra* note 6.

38. Emily Maltby, *Collateral Damage in Lending: With Assets Harder to Value, More Small Businesses Need Cash to Get a Loan*, WALL ST. J., July 22, 2010, <http://online.wsj.com/article/SB10001424052748703792704575366992490339102.html?KE> YWORDS=Collateral+Damage+in+Lending.

39. *See supra* note 8.

40. *See discussion infra* Part III.

41. *See discussion infra* Section III.B.

der these circumstances or whether it is abusing its use of the insecurity clause.<sup>42</sup>

An insecurity clause allows a lender to request payment in full whenever the lender “deems itself insecure.”<sup>43</sup> The lender cannot arbitrarily decide that it feels insecure, but it does have some discretion over this decision. However, courts should choose to limit this discretion by an obligation to act in “good faith.”<sup>44</sup> It is possible that the value of the collateral could decrease but that the lender could still feel confident that it will receive payment from the lender.<sup>45</sup> This decrease may happen, for example, when an overall market has declined, but the business supported by the commercial mortgage is still running successfully.<sup>46</sup> While the results are sometimes harsh, an acceleration clause triggered by nonpayment is generally accepted.<sup>47</sup> On the other hand, if other events trigger an insecurity clause, such as a large overall market downturn, and the borrower has not defaulted, then there should be some regulation to limit the lender’s ability to use the insecurity clause.<sup>48</sup>

Insecurity clauses are frequently used in commercial mortgage lending to protect the lender from situations where it seems that the borrower will be unable to repay the loan, but nothing in the loan agreement has been expressly violated.<sup>49</sup> These clauses allow a lender to accelerate the obligation of the borrower to repay the lender.<sup>50</sup> Because these clauses can force a borrower to default, even if the borrower has been making his payments, there should be some regulation of their use.<sup>51</sup> Specifically, there should be a way to determine whether a lender is actually insecure before it uses an insecurity clause. For commercial lending pertaining to personal property, the Uniform Commercial Code (U.C.C.) establishes a standard that the lender must meet before an insecurity clause can be implemented, which includes a re-

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42. See discussion *infra* Section III.B.

43. U.C.C. § 1-309 (2004).

44. *Id.* “Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.” *Id.* § 1-304. Good faith means “[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.” BLACK’S LAW DICTIONARY, *supra* note 1, at 762.

45. Collateral is “[p]roperty that is pledged as security against a debt.” BLACK’S LAW DICTIONARY, *supra* note 1, at 297.

46. Please see discussion of the example provided in the Introduction of this Note.

47. See *supra* note 33.

48. See discussion *infra* Section III.B.

49. See *supra* note 8.

50. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 8.1 cmt. a (1997).

51. See discussion *infra* Part III.

quirement to act in good faith.<sup>52</sup> The U.C.C. does not consider a commercial mortgage to be a secured transaction.<sup>53</sup> Therefore, no uniform code exists to address the use of insecurity clauses in commercial mortgage lending.

Under common law, the courts determined that acceleration clauses are not a penalty and are allowed in secured transactions, but they established limitations on these clauses.<sup>54</sup> One way in which an acceleration clause would not be enforced is if the lender acted in bad faith or the clause was unconscionable.<sup>55</sup> The purpose of an acceleration clause is to reduce the lender's risk of nonpayment by the borrower.<sup>56</sup> The acceleration clause allows a lender to collect immediately after default, rather than waiting for each payment's due date.<sup>57</sup> The insecurity clause expands this protection by allowing a lender to recover payment when the lender feels insecure.<sup>58</sup> However, the lender should not be able to exercise this discretion without some limitation.<sup>59</sup> The logic behind limiting this discretion is that the clause should protect the lender, but it should not be used offensively by a lender to force the borrower to pay earlier than agreed to in the loan.<sup>60</sup> While this power should be protected, it should not be abused.<sup>61</sup> Therefore, whether or not an insecurity clause is valid involves a discussion of whether or not the party acted in good faith.

## B. The Duty of Good Faith in Contracts

Generally, "[e]very contract imposes upon each party a duty of good faith . . . in its performance and its enforcement."<sup>62</sup> Courts have adopted an

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52. See *supra* note 28; see also Frederick P. Leaf, *Acceleration Clauses in Sales and Secured Transactions: The Debtor's Burden Under Section 1-208 of the U.C.C.*, 11 B.C. L. REV. 531, 539 (1970).

53. U.C.C. § 9-109 (2004).

54. See *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 885 (N.Y. 1930); see also Leaf, *supra* note 52, at 532.

55. See Leaf, *supra* note 52, at 532.

56. See Michael Giusto, Note, *Mortgage Foreclosure for Secondary Breaches: A Practitioner's Guide to Defining "Security Impairment,"* 26 CARDOZO L. REV. 2563, 2565 (2005).

57. See David Hahn, *The Roles of Acceleration*, 8 DEPAUL BUS. & COM. L.J. 229, 238 (2010).

58. See *supra* note 8.

59. See discussion *infra* Part III.

60. *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1376 (9th Cir. 1979).

61. Lenders should be able to collect the amount due when a debtor defaults, rather than having to wait for each installment payment to come due. However, lenders should not be able to arbitrarily implement an insecurity clause.

62. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). Similarly, the U.C.C. defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 1-201 (2004). The U.C.C. applies the obligation of good faith to all transactions in Section 1-304: "Every contract or duty within [the Uniform Commercial



implied duty of good faith in a number of contractual contexts.<sup>63</sup> Nonetheless, it remains unclear whether an implied duty of good faith would apply specifically to the use of an insecurity clause in commercial mortgages.<sup>64</sup> In order to protect commercial borrowers from the arbitrary application of insecurity clauses, courts should imply a duty of good faith for these lenders in their use of insecurity clauses.<sup>65</sup> More specifically, the courts should require that lenders do not act in bad faith when using an insecurity clause.<sup>66</sup>

Some courts are unwilling to imply a duty of good faith to contracts without significant limitation. The Texas Supreme Court ruled in *English v. Fisher* that an implied duty of good faith could not overcome express contracted-for terms.<sup>67</sup> The Texas Supreme Court adamantly rejected the notion that there should be an implied duty of good faith in every contract.<sup>68</sup> It warned that adopting an implied covenant of good faith in every contract would jeopardize a party in a contract that tries to enforce the terms of the contract.<sup>69</sup> This decision is consistent with the belief that parties are free to contract as they please, and courts should not be able to adjust their agreements.<sup>70</sup> Likewise, some commentators warn that “[t]he inconsistent application of the good faith doctrine to lending practices adds uncertainty and other costs to business transactions in abrogation of the fundamental pur-

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Code] imposes an obligation of good faith in its performance and enforcement.” *Id.* § 1-304. More specifically, the U.C.C. applies the obligation of good faith to insecurity clauses. *Id.* § 1-309. However, the U.C.C. only applies to commercial consumer transactions and does not govern commercial mortgage loans. *Id.* § 9-109.

63. 17A AM. JUR. 2D *Contracts* § 370 (2004) (citing *Carrico v. Delp*, 490 N.E.2d 972, 976 (Ill. App. Ct. 1986); *Am. Bankers’ Ins. Co. of Fla. v. Wells*, 819 So. 2d 1196, 1206 (Miss. 2001)).

64. See Werner F. Ebke & James R. Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 49 OHIO ST. L.J. 1237, 1239 (1989).

65. See *infra* Part III.

66. Bad faith is “[d]ishonesty of belief or purpose.” BLACK’S LAW DICTIONARY, *supra* note 1, at 159. According to a comment in the Restatement:

A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

67. Ebke & Griffin, *supra* note 64, at 1242-43.

68. See *id.* at 1242.

69. *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983). Fisher purchased a home from English using a promissory note secured by a lien on the house as consideration. *Id.* In 1979, the home was destroyed in part by a fire. *Id.* There was a provision in the deed that stated that any insurance proceeds would go to English. *Id.* at 522-23. The Texas Supreme Court was unwilling to overturn this explicit contractual language based on an implied duty of good faith. *Id.* at 522.

70. See Ebke & Griffin, *supra* note 64, at 1243.

poses of commercial law.”<sup>71</sup> The acceptance of implied covenants of good faith by the courts could have the ripple effect of making lenders hesitant to accelerate payment in any fashion.<sup>72</sup> This hesitancy could increase the cost of doing business for lenders and, ultimately, for borrowers who would find themselves with “greater difficulty in obtaining loans, higher interest rates, and less flexible credit arrangements.”<sup>73</sup>

On the other hand, some jurisdictions are willing to imply a duty of good faith more broadly to contract cases. A leading example of a court implying a duty of good faith to a contract is *K.M.C. Co. v. Irving Trust Co.*<sup>74</sup> In *K.M.C. Co.*, the Sixth Circuit held that the lender had breached an implied duty of good faith.<sup>75</sup> Typically, courts imply good faith in situations where one party is required to exercise a certain level of discretion.<sup>76</sup> In *K.M.C. Co.*, Irving Trust Company was able to exercise discretion both in its decision to advance funds and its ability to demand payment.<sup>77</sup> The court held that this discretion had to be limited by an obligation of good faith.<sup>78</sup> Lenders similarly exercise their discretion in the execution of insecurity clauses in commercial mortgages.

When a commercial mortgage includes an insecurity clause, the lender theoretically bargained for that clause.<sup>79</sup> The clause gives the lender the power to demand payment earlier than the due date if the lender feels insecure.<sup>80</sup> The lender is exercising its discretion to make this determination of

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71. Mark Snyderman, Comment, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1335, 1338 (1988).

72. *See id.* at 1337.

73. *Id.*

74. Cheryl Anderson, Note, *Lender Liability: Breach of Good Faith in Lending and Related Theories*, 64 N.D. L. REV. 273, 291 (1988).

75. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 762 (6th Cir. 1985). Irving Trust Company appealed from a judgment entered against it for breach of a financing agreement. *Id.* at 754. K.M.C. was involved in the grocery business. *Id.* In 1979, the two parties entered into a financing agreement that gave Irving a security interest in K.M.C.'s accounts receivable and inventory. *Id.* Additionally, the agreement provided K.M.C. a line of credit. *Id.* On March 1, 1982, Irving refused to advance money requested by K.M.C., which would have increased the total loan amount. *Id.* K.M.C. argued that Irving breached its duty of good faith performance implied in the agreement when it refused to advance the money without giving any notice and that the collapse of the company was the result of this refusal. *Id.* Irving contended that K.M.C. was already failing, and that their decision not to advance the money was made in good faith. *Id.*

76. STEVEN J. BURTON, *PRINCIPLES OF CONTRACT LAW* 433 (3d ed. 2006).

77. *K.M.C. Co.*, 757 F.2d at 760.

78. *Id.*

79. *See Burton, supra* note 76, at 434 (explaining this principle in the context of a termination clause).

80. This scenario is different from a demand note, which does not have an implied duty of good faith, because a demand note is structured so that the lender can demand pay-

insecurity. If a lender in good faith believes that it will not be able to recover payment from the borrower, then the lender should be able to use the insecurity clause because it bargained for this right.<sup>81</sup> However, if the lender uses this clause for another reason, one that it did not bargain for, then the courts should not allow it. Using the clause in this manner would allow the lender to get something that it did not bargain for. The lender would receive payment earlier than arranged in the contract, even though the lender is secure. Early payment in this manner is not the purpose of an insecurity clause.<sup>82</sup> The clause is supposed to protect the lender from insecurity.<sup>83</sup> The lender should be able to use the insecurity clause when it deems itself insecure, but the courts should limit the use by implying a duty of good faith.<sup>84</sup>

### C. The Relationship Between Appraisals and Commercial Mortgage Lending Agreements

The appraiser plays an important role in commercial mortgage loans because the appraiser determines the current value of the collateral.<sup>85</sup> The collateral provides a second avenue of collection for the lender if the borrower does not pay in full, so the value of the collateral is relevant.<sup>86</sup> The appraiser's determination can greatly affect the loan when it is formed and later if the collateral is reappraised.<sup>87</sup> Appraising is an art, not a science. In order to be relevant, an appraisal must be based upon "reliable and timely information on the market value of the real estate collateral."<sup>88</sup> Appraisers use comparable properties to determine the value of the property they are

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ment at any time and for any reason. EDWARD F. MANNINO, LENDER LIABILITY AND BANKING LITIGATION § 5.03 (2012).

81. See BURTON, *supra* note 76, at 434 (explaining this principle in the context of a termination clause).

82. See *supra* note 8. The insecurity clause allows the lender to demand payment if it believes the borrower will default, so if the lender is not actually insecure about receiving payment from the borrower, then it should not be able to use the insecurity clause. *Id.*

83. *Id.*

84. BURTON, *supra* note 76, at 433.

85. See Interagency Appraisal and Evaluation Guidelines, 75 Fed. Reg. 77,450, 77,450 (Dec. 10, 2010).

86. See *supra* notes 6, 7 and accompanying text.

87. If the appraiser decreases the value of the secured property, then the property may no longer be considered sufficient to act as a second avenue of recovery for the lender. See *supra* notes 6, 7 and accompanying text.

88. *Examining the Continuing Crisis in Residential Foreclosures and the Emerging Commercial Real Estate Crisis: Perspectives from Atlanta Before the Subcomm. on Domestic Policy of the H. Comm. on Oversight & Gov't Reform*, 111th Cong. 169 (2009), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg65548/pdf/CHRG-111hhrg65548.pdf> [hereinafter *Examining the Continuing Crisis*] (statement of Jon D. Greenlee, Associate Director, Div. of Banking Supervision and Regulation, Fed. Reserve).

appraising.<sup>89</sup> The number of good comparable properties available can affect how realistic the valuation of the property actually is; “[t]he greater the number of good comparable data used, the better the result, provided a proper analysis is made.”<sup>90</sup> Every choice the appraiser makes can affect the appraised value of the property.<sup>91</sup> This uncertainty makes relying on appraisal information very problematic in the application of insecurity clauses. This variability should be taken into consideration when determining if a lender is insecure, particularly when the reappraisal is the primary basis for the insecurity claim.

### 1. *The Potential Effects of Inaccurate Appraisals*

A major concern for borrowers is the potential variance of appraisals.<sup>92</sup> An appraisal is ultimately just an estimate based on a variety of factors, such as “general economic conditions” and “the sales and holding prices of comparable properties.”<sup>93</sup> The result of this process is the potential for imprecise appraisals. If a lender has collateral reappraised and the collateral is appraised at a lower value than it originally was, then it could be devastating to a borrower. The lender could potentially deem itself insecure based on this lower appraisal.<sup>94</sup> The appraiser’s valuation will determine whether the collateral is still considered a sufficient method of collection for the lender.<sup>95</sup> It is daunting for an appraisal to have this much power because it is subjective and uncertain by nature.<sup>96</sup> When a lender applies an insecurity clause based on the underlying value of the collateral, the court should consider the influence the appraisal had on the lender’s determination.

Today’s market has also substantially affected the reliability of appraisals. Because of the economic downturn and the decline in the commercial real estate market, there has been a decrease in the number of normal property sales.<sup>97</sup> In addition, the sales that have occurred have often been distressed sales.<sup>98</sup> These types of sales do not accurately reflect the value of the collateral, but rather the value in a depressed market where almost all

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89. See *The Real Estate Appraisal Process*, *supra* note 12.

90. CAL. DEP’T OF REAL ESTATE, REFERENCE BOOK—A REAL ESTATE GUIDE 342-43 (2010), available at [http://www.dre.ca.gov/pdf\\_docs/ref17.pdf](http://www.dre.ca.gov/pdf_docs/ref17.pdf).

91. See generally K. Lee Hyder, *The Appraisal Process*, 75 APPRAISAL J. 227 (2007) (explaining the basics of the appraisal process).

92. See generally *id.*

93. *Id.* at 229-30.

94. See *supra* note 8.

95. See *supra* notes 6, 7 and accompanying text.

96. See generally Robert F. Reilly, *What Lawyers Need to Know About Real Estate Appraisal Reports*, PRAC. REAL EST. LAW., Jan. 2005, at 7 (describing the components of a real estate appraisal report).

97. See *Examining the Continuing Crisis*, *supra* note 88, at 162-63, 165, 170.

98. *Id.* at 165-66, 169.

property decreases in value.<sup>99</sup> As the market worsens, an appraisal becomes more and more of an estimate and less of a comparison because there are fewer truly comparable properties to use in the appraisal.<sup>100</sup> In times like these, it is even more important for the courts to imply a duty of good faith to the use of insecurity clauses.

## *2. How Minimal Regulation Has Negatively Impacted the Appraisal Industry*

The Ethical Rules of the Uniform Standards of Professional Appraisal Practices (USPAP) state, “An appraiser must promote and preserve the public trust inherent in appraisal practice by observing the highest standards of professional ethics.”<sup>101</sup> More specifically, in regard to an appraiser’s conduct, the appraiser “must not perform an assignment with bias,” “must not advocate the cause or interest of any party or issue,” and “must not accept an assignment that includes the reporting of predetermined opinions and conclusions.”<sup>102</sup> Although these rules may provide some guidance for how appraisers should behave and may provide some protection for third parties, who can be directly affected by an appraisal, overall, the “appraisal industry lacks internal regulations.”<sup>103</sup> Commercial mortgage loans are dependent on the value of their underlying collateral. The underlying contract is based on the collateral providing a sufficient second avenue of collection if the borrower fails to pay.<sup>104</sup> If the industry that determines the value of the collateral “lacks internal regulation[,]” this lack of regulation should raise concern for a borrower whose loan is dependent upon these valuations.<sup>105</sup>

One reason Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was to respond to the lack of regulation in the appraisal industry and the potential harsh result an appraisal can create.<sup>106</sup> However, FIRREA has not effectively regulated the appraisal industry because the Act left the appraisal industry self-regulated with minimal federal guidelines.<sup>107</sup> As a self-regulated industry, the apprais-

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99. *See id.*

100. *See How Do Market Conditions Affect How a Real Property Appraiser Analyzes Comparable Sales?*, ACCUVAL, <http://www.accuval.net/insights/askappraiser/detail.php?ID=19> (last visited Apr. 19, 2012).

101. APPRAISAL STANDARDS BD., APPRAISAL FOUND., UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE U-7 (2012), *available at* <http://www.uspap.org> [hereinafter USPAP].

102. *Id.*

103. Cherokee W. Wooley, Comment, *Regulation of Real Estate Appraisers and Appraisals: The Effects of FIRREA*, 43 EMORY L.J. 357, 357 (1994).

104. *See supra* note 6.

105. Wooley, *supra* note 103, at 357.

106. *Id.* at 358-59.

107. *Id.* at 359.

al industry has not successfully protected all of the users of appraisals.<sup>108</sup> In a commercial mortgage scenario, the appraiser's duty lies with the one that hires it, typically the lender.<sup>109</sup> This setup leaves the borrower somewhat unprotected in regard to the appraiser's actions. According to the USPAP,<sup>110</sup> appraisers do not normally have an ethical duty towards the third parties affected by their appraisals.<sup>111</sup> Yet, the appraisers can have considerable influence over these third parties. This potential influence is frightening for a borrower because a lender uses the appraiser's valuation to determine the value of the collateral, but the appraiser historically has no ethical duty to the borrower.<sup>112</sup> Appraisers know that third parties often rely on their reports to obtain or maintain loans, but the appraisers owe no duty to the third party.<sup>113</sup> There is no established good faith requirement among the industry, so if an appraisal is inaccurate, the property owner does not have many avenues to pursue to hold the appraiser accountable for the fallout from this lower appraisal.

Additionally, regulatory pressures have affected the commercial mortgage industry and contributed to lenders' bad faith implementation of insecurity clauses. When regulators force banks "to write down performing commercial real estate loans based solely on appraisals and absorption rates," this regulation raises concern for the entire industry.<sup>114</sup> Bank managers' concern is that these loans are being written down without considering "the borrower's ability to repay its loan, the borrower's history of repaying other loans with the lender, favorable loan-to-value ratios and guarantors."<sup>115</sup> The argument made by regulators in response to this argument is that the value of the underlying collateral is generally linked to the likelihood of repayment because both are based on the success of the project.<sup>116</sup> Regulators believe that the collateral can thus be a strong indicator of the

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108. See *id.* at 364-66.

109. 31 AM. JUR. 2D *Proof of Facts* § 1 (1982).

110. "[T]he Federal Reserve requires its regulated institution to have real estate appraisals that meet minimum appraisal standards, including the Uniform Standards of Professional Appraisal Practice, and contain sufficient information to support the institution's credit decision." *Examining the Continuing Crisis*, *supra* note 88, at 169.

111. USPAP, *supra* note 101, at U-2, U-7.

112. 31 AM. JUR. 2D *Proof of Facts* § 1 (1982) ("When these third persons are so injured, the law has not always gone to their aid, because of an absence of privity of contract or a lack of a duty of care . . .").

113. See generally USPAP, *supra* note 101 (explaining that borrowers are not intended users if the lender is the client).

114. *Bank Examiners Defend Collateral Valuation Policies Before House Committees*, APPRAISER NEWS ONLINE, Mar. 3, 2010, <http://www.appraisalinstitute.org/ano/Share/Default.aspx?volume=11&numbr=5/6&id=9760>.

115. *Id.* (quoting Stephen Andrews, President and CEO of Bank of Alameda).

116. *Id.*

success of the project and the likelihood of repayment.<sup>117</sup> Although there is some truth in this relationship between the value of the collateral and the likelihood of repayment, there are times when the connection could be misleading. For example, the current market is in a decline, so most commercial real estate has decreased in value.<sup>118</sup> In a situation like this, the value of the collateral may be less representative of the borrower's ability to repay and more representative of the overall change in the market.

Recently, several federal agencies have issued appraisal guidelines, which may have some protection for borrowers who are concerned with the uncertainty of appraisals.<sup>119</sup> These guidelines take into consideration technological advancements in the field of appraisal as well as industry developments.<sup>120</sup> One objective of the guidelines is to promote consistency among appraisals.<sup>121</sup> In particular, the guidelines outline how real estate collateral should be evaluated and updated.<sup>122</sup> Among other requirements, the guidelines require that a real estate appraisal program at a financial institution make sure that those performing and reviewing appraisals are independent, that the appraisal contains sufficient information, and that criteria are established for monitoring property values.<sup>123</sup> The guidelines also address issues that can arise because of undue influence exerted by the employer of the appraiser.<sup>124</sup> Specifically, institutions cannot communicate a predetermined property value to the appraiser or specify a minimum value for the property.<sup>125</sup> In the future, these guidelines may help protect third parties from the potential burden an appraiser can cause them.

#### D. The Current Commercial Real Estate Market

At the end of 2007, a noticeable decline began in the United States' economy and in the commercial real estate market.<sup>126</sup> Although it has done better than the residential mortgage market, the commercial real estate mar-

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117. *See id.*

118. *See infra* Section I.D.

119. Interagency Appraisal and Evaluation Guidelines, 75 Fed. Reg. 77,450, 77,450-51.

120. *Id.*

121. *Id.* at 77,450, 77,451.

122. Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Issue Final Appraisal and Evaluation Guidelines (Dec. 2, 2010), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20101202a.htm>.

123. Interagency Appraisal and Evaluation Guidelines, 75 Fed. Reg. at 77,457.

124. *See id.*

125. *Id.*

126. ECONOMIC ACTIVITY, *supra* note 19, at 1.

ket is also facing its own problems.<sup>127</sup> Because of problems with the commercial real estate market, the number of “troubled commercial real-estate loans is skyrocketing.”<sup>128</sup> At the end of 2010, nearly nine percent of commercial real estate mortgage loans are delinquent.<sup>129</sup> Commercial lenders have not struggled with commercial mortgage default rates this high since 1992.<sup>130</sup> This market could cause problems for all banks, especially smaller more regionalized banks, which usually hold a larger percentage of commercial real estate loans than other loans.<sup>131</sup> As the value of their collateral decreases, the likelihood that they will suffer losses increases.<sup>132</sup> In addition, the high default rate on commercial mortgages could “impinge on their ability” to make loans in other areas, such as to consumers.<sup>133</sup> This type of problem is not limited to a few large banks.<sup>134</sup> This problem affects many banks that are involved in commercial real estate loans.<sup>135</sup> It is estimated that banks could ultimately suffer \$250 billion in losses from these commercial

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127. Kerry E. Grace, *Mortgage-Securities Defaults Rise*, WALL ST. J., Jan. 21, 2009, at C11, available at <http://online.wsj.com/article/SB123250443252201023.html?KEYWORDS=secured+commercial+collateral#dummy>.

128. Lingling Wei, *Banks Get New Rules on Property*, WALL ST. J., Oct. 31, 2009, at B1, available at <http://online.wsj.com/article/SB125694507086819833.html?KEYWORDS=commercial+collateral>KEYWORDS%3Dcommercial+collateral.

129. Floyd Norris, *The Upside? Things Could Be Worse*, N.Y. TIMES, Dec. 24, 2010, at B1, available at [http://www.nytimes.com/2010/12/24/business/24norris.html?\\_r=1&scp=3&sq=commercial%20loan&st=cse](http://www.nytimes.com/2010/12/24/business/24norris.html?_r=1&scp=3&sq=commercial%20loan&st=cse).

130. Dealbook, *Study Shows Commercial Property Trouble at U.S. Banks*, N.Y. TIMES, May 25, 2010, <http://dealbook.nytimes.com/2010/05/25/study-shows-commercial-property-trouble-at-u-s-banks/>.

131. *Id.*

132. See Robb Mandelbaum, *Can Government Help Small Businesses?*, N.Y. TIMES YOU'RE THE BOSS BLOG (July 29, 2010, 7:00 AM), <http://boss.blogs.nytimes.com/2010/07/29/can-government-help-small-businesses/?scp=11&sq=%22commercial%20loan%22&st=cse>. Mandelbaum states:

[T]he banks trying to get into compliance find that the current market value of this commercial real estate will not support the value of the loans that are currently outstanding, and in many cases the borrowers do not have the reserve equity that is necessary to downsize the loan. Many of these borrowers are forced to default on the loans. And there is no functioning market for the bank to sell that property except at distressed prices. Right now the distressed values are 20 to 30 cents on the dollar, which drives the banks out of business, because it depletes their capital.

*Id.*

133. Dan Levy & David Henry, *Commercial Mortgage Default Rate in U.S. More Than Doubles*, BLOOMBERG, Feb. 24, 2010, [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aj9Yttz\\_UYxg](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aj9Yttz_UYxg) (quoting Sam Chandan, Global Chief Economist, Real Capital Analytics).

134. See Demyanyk & Cherny, *supra* note 23.

135. *Id.*



real estate loans.<sup>136</sup> Despite the national breadth of this issue, the regulation of these loans is governed separately by the states.<sup>137</sup>

## II. VARYING APPROACHES TO REGULATION OF COMMERCIAL MORTGAGE LENDING

Currently, there is no uniform standard to regulate the use of insecurity clauses in commercial mortgage lending. This regulation is generally left up to individual state jurisdictions.<sup>138</sup> In comparison to commercial lending for personal property, which is governed by the U.C.C., commercial lending involving real estate does not have a specific statutory standard that requires good faith in the application of insecurity clauses.<sup>139</sup> This lack of a uniform standard leaves the states with the power to determine how this type of clause should be regulated. Although jurisdictions may differ in their approaches to the application of good faith in contracts, most imply a duty of good faith in all contracts.<sup>140</sup> Even though many courts have addressed the issue of an implied duty of good faith in contracts, there is little precedent regarding the role of this duty in the application of insecurity clauses in commercial mortgages.<sup>141</sup>

### A. How Various States Have Approached the Implied Duty of Good Faith

Many courts have implied a duty of good faith in contracts across a wide variety of contractual arenas.<sup>142</sup> However, courts have yet to fully address what constitutes a breach of the implied duty of good faith in connection with commercial mortgages.<sup>143</sup> More specifically, it is unclear whether the inappropriate use of an insecurity clause can breach this duty. States

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136. Nicole Lucht & Buck Wargo, *Las Vegas Braces for Commercial Foreclosures*, LAS VEGAS SUN, Apr. 17, 2009, <http://www.lasvegassun.com/news/2009/apr/17/lv-braces-commercial-foreclosures/> (referencing *The Wall Street Journal*).

137. See Legal Info. Inst., *Real Estate Transactions: An Overview*, CORNELL U. L. SCH., [http://topics.law.cornell.edu/wex/Real\\_estate\\_transactions](http://topics.law.cornell.edu/wex/Real_estate_transactions) (last visited Apr. 19, 2012).

138. See *id.* “Real estate transactions are governed by a wide body of federal statutes and a combination of state statutes and common law.” *Id.* “The requirements established by state law often differ significantly from one state to the next.” *Id.*

139. See discussion *supra* Section I.B.

140. See discussion *infra* Section II.A.

141. As of February 24, 2011, a search on Westlaw in the “All State and Federal Cases” database with the search terms “‘commercial mortgage’ /p insecure!” yielded one result. This result, *In re Friesenhahn*, 169 B.R. 615 (Bankr. W.D. Tex. 1994), is not relevant to this Note.

142. See discussion *supra* Section I.B.

143. See discussion *supra* Section I.B.

vary in their interpretations of the implied duty of good faith; however, the trend seems to favor implying a duty of good faith into contracts.<sup>144</sup>

### 1. *Florida*

Florida is one of the states in the nation that has been hit extremely hard by the current foreclosure crisis.<sup>145</sup> The magnitude of the crisis has made the state a particularly relevant player in the issue of bad faith implementation of insecurity clauses. As explained by the Supreme Court of Florida in *Delgado v. Strong*, “[i]t is well-established that courts of equity may refuse to foreclose a mortgage when an acceleration of the due date would render the acceleration unconscionable and the result would be inequitable and unjust.”<sup>146</sup> The holding in *Delgado* established that if a technical error alone activated an acceleration clause, the court could deny foreclosure because it would be unjust.<sup>147</sup> Florida mortgage law specifies that the court of equity has the power to help a mortgagor whose mortgage is accelerated by unjust conduct of the mortgagee.<sup>148</sup> This general rule also allows relief to be given to the mortgagor anytime a default caused by an “unharmful breach of a condition of the mortgage” would cause the foreclosure to be unjust.<sup>149</sup> In *Clark v. Lachenmeier*, the plaintiff argued that the defendant’s failure to get the plaintiff’s consent before selling the secured property to another party, which was required by the mortgage agreement, warranted foreclosure.<sup>150</sup> However, the court disagreed and stated that the foreclosure should be denied because it would be inequitable to proceed with the foreclosure on only that basis.<sup>151</sup>

Florida law establishes that if a lender in a personal property secured transaction wants to accelerate payment or foreclose on the collateral as a

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144. The following states that are discussed represent a diverse geographical sample.

145. The Rogue Economist, *A Rush to Foreclose: 5 Reasons Why Your Loan Officer Wants Your House*, ARTICLEB.COM (Oct. 23, 2010, 11:57 PM), <http://www.published-articles.com/Art/52330/208/A-Rush-To-Foreclose-5-Reasons-Why-Your-Loan-Officer-Wants-Your-House.html>.

146. 360 So. 2d 73, 75 (Fla. 1978). Mortgagors purchased some industrial property from mortgagees, but were unaware that they had a duty to insure the property. *Id.* at 74. After learning of this duty, the mortgagors tried to insure the property. *Id.*

147. *Id.* at 75-76. The court ultimately allowed the foreclosure to proceed in this case because although it was only a technical error that had triggered the acceleration clause, the property was in fact insecure. *Id.* This scenario was sufficient to allow the foreclosure to proceed. *Id.* at 76.

148. *Clark v. Lachenmeier*, 237 So. 2d 583, 584-85 (Fla. Dist. Ct. App. 1970); see also *Wootton v. Matheson*, 439 So. 2d 1007, 1008 (Fla. Dist. Ct. App. 1983); *Amerifirst Fed. Sav. & Loan Ass’n of Miami v. Century 21 Commodore Plaza, Inc.*, 416 So. 2d 45, 46 (Fla. Dist. Ct. App. 1982).

149. *Clark*, 237 So. 2d at 585 (quoting 22 FLA. JUR. *Mortgages* § 214 (1965)).

150. *Id.* at 584.

151. *Id.* at 585.

result of the lender becoming insecure, the lender must have a good faith belief that future payments will be impaired.<sup>152</sup> In regard to secured personal property transactions, Florida law explains that a lender acts in bad faith if it “has no reason to feel less secure on the date that it repossesses collateral than it did when the note was executed.”<sup>153</sup> The traditional purpose of an insecurity clause was to protect the lender’s security.<sup>154</sup> Florida courts have held that a lender may enforce an insecurity provision in a secured transaction when its security has been impaired.<sup>155</sup>

## 2. Massachusetts

Massachusetts’s statutes only address good faith in the context of the U.C.C. Massachusetts’s statute imposes an “obligation of good faith in [the] performance” of any transaction governed by the Massachusetts U.C.C.<sup>156</sup> Outside of this context, there is no statutory reference to good faith being required in the implementation of insecurity clauses. Instead, the law has developed through the courts.

In Massachusetts, the courts have established that there is a duty in contracts to act in good faith, but the courts have not uniformly defined what that duty entails.<sup>157</sup> In *Fortune v. National Cash Register Co.*, the Supreme Judicial Court of Massachusetts held that there was an implied duty of good faith in a contract regarding an at will employment termination.<sup>158</sup> Similarly, in the commercial loan context, the Massachusetts Court of Appeals held that every contract has an implied duty of good faith.<sup>159</sup> In this

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152. 47 FLA. JUR. 2d *Secured Transactions* § 126 (2012).

153. 6 FLA. JUR. 2d *Bills and Notes* § 110 (2012).

154. *Consol. Capital Properties, II, Ltd. v. Nat’l Bank of N. Am.*, 420 So. 2d 618, 622 (Fla. Dist. Ct. App. 1982).

155. *Id.* at 622-23 (citing *First Fed. Sav. & Loan Ass’n of Englewood v. Lockwood*, 385 So. 2d 156, 159, 160 (Fla. Dist. Ct. App. 1980); *Woodcrest Apartments, Ltd. v. IPA Realty Partners Richardson Palmer, 3rd Investment KG*, 397 So. 2d 364, 366 (Fla. Dist. Ct. App. 1981)).

156. MASS. GEN. LAWS ch. 106, § 1-203 (2011).

157. Tory A. Weigand, *The Duty of Good Faith and Fair Dealing in Commercial Contracts in Massachusetts*, 88 MASS. L. REV. 174, 174 (2004). “Despite its time-honored status, however, its scope and application remain elusive and ill-defined.” *Id.*; see also Lori J. Henkel, Annotation, *Bank’s Liability for Breach of Implied Contract of Good Faith and Fair Dealing*, 55 A.L.R. 4TH 1026 (Supp. 2012) (citing *T.W. Nickerson, Inc. v. Fleet Nat’l Bank*, 898 N.E.2d 868, 879 (Mass. App. Ct. 2009)).

158. 364 N.E.2d 1251, 1256 (Mass. 1977). In this case, a salesman brought an action against a former employer regarding his at will termination. *Id.* at 1253.

159. *Shawmut Bank, N.A. v. Wayman*, 606 N.E.2d 925, 928 (Mass. App. Ct. 1993). In this case, a guarantor of a commercial loan claimed that the bank had broken its implied duty of good faith. *Id.* Although the court agreed that there was an implied duty of good faith that was applicable to all contracts, including the contract at issue, the court held that the bank had not violated their duty to act in good faith. *Id.*

lender/borrower context, the implied duty of good faith “requires that the lender be honest in its dealings with borrowers and not purposefully injure their right to obtain the benefit of the contract.”<sup>160</sup> Despite the courts’ uniformity in holding that there is an implied duty of good faith in contracts, the duty of good faith has been determined on a case-by-case factual analysis of each particular contract rather than by a defined standard.<sup>161</sup>

### 3. Michigan

Like many other jurisdictions, Michigan courts have held that a duty of good faith is implied in contracts, specifically commercial loan agreements, but have been careful to not imply this duty when the contract terms are clear.<sup>162</sup> They have also recognized that this duty is relevant when one party is able to exercise discretion over its performance under the contract.<sup>163</sup> More recently, the Sixth Circuit found that there was an implied duty of good faith “only where one party to the contract makes its performance a matter of its own discretion.”<sup>164</sup> The court restricts the use of the good faith covenant to circumstances where one party’s performance is under its discretion.<sup>165</sup> One way discretion arises in a contract is when the contract “defers decision on a particular term.”<sup>166</sup> By this interpretation, insecurity clauses would involve discretion because the term is not decided until a later time when one party exercises its discretion. Lenders use their discretion to determine when they are insecure; therefore, lenders should still be bound by an implied duty of good faith in their use of insecurity clauses.

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160. Henkel, *supra* note 157 (citing *FAMM Steel, Inc. v. Sovereign Bank*, 571 F.3d 93, 100 (1st Cir. 2009) (applying Massachusetts law)).

161. Weigand, *supra* note 157, at 174, 183.

162. *Van Arnen Co. v. Mfrs. Hanover Leasing Corp.*, 776 F. Supp. 1220, 1222-23 (E.D. Mich. 1991). The lender did not breach the implied duty of good faith by refusing to make the requested loans to the borrower because the borrower did not submit some of the required documentation by the arranged date. *Id.* at 1224; *see also* *Gen. Aviation, Inc. v. Cessna Aircraft Co.*, 915 F.2d 1038, 1041-42 (6th Cir. 1990) (finding that the manufacturer did not breach an implied duty of good faith when executing a termination agreement because the terms of the contract were express and the manufacturer did not act in bad faith).

163. *Burkhardt v. City Nat’l Bank of Detroit*, 226 N.W.2d 678, 680 (Mich. Ct. App. 1975). The Burkhardts made monthly payments to the bank towards their loan. *Id.* at 679. There were escrow accounts set up as part of the agreement, and the bank used its discretion in choosing an accounting method to create and maintain the accounts. *Id.*

164. *Stephenson v. Allstate Ins. Co.*, 328 F.3d 822, 826 (6th Cir. 2003).

165. *Id.*

166. *Hubbard Chevrolet Co. v. Gen. Motors Corp.*, 873 F.2d 873, 876-77 (5th Cir. 1989).

#### 4. Illinois

In 1987, the Illinois Mortgage Foreclosure Act was enacted with the purpose of being a “comprehensive statutory scheme governing all mortgage foreclosures in Illinois [and] codif[ying] much of the common law of foreclosures.”<sup>167</sup> However, there is no mention in the Act of insecurity clauses or good or bad faith in regard to a lender’s actions.<sup>168</sup> This comprehensive law, written only about twenty years ago, does not mention any of the problems associated with a lender’s bad faith implementation of an insecurity clause.<sup>169</sup> The current statute still does not address lender liability with regard to the application of insecurity clauses.<sup>170</sup>

Although some Illinois courts have held that there is an implied duty of good faith in all contracts, others have declined to extend the implied duty of good faith to cases outside the realm of insurance and employment.<sup>171</sup> In *Koehler v. First National Bank of Louisville*, the Appellate Court of Illinois held that “[i]n the absence of compelling policy considerations,” the implied duty of good faith could not be extended to a particular area of law.<sup>172</sup> The Illinois courts have addressed the issue of an implied duty of good faith towards a party that is in a position with discretionary power.<sup>173</sup> In *Carrico v. Delp*, the Appellate Court of Illinois held that “[g]ood faith . . . requires the party vested with contractual discretion to exercise it reasonably, and he may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.”<sup>174</sup>

#### 5. New York

New York, like many other states, does not have a statute that governs the application of insecurity clauses to real property transactions. Instead, the law has been developed solely through the courts. The New York Court of Appeals held that the enforcement of an acceleration clause when interest was not paid within the twenty-one days required in the loan agreement was

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167. Robert T. Biskup, *Defaulting Borrowers Beware: The Law Is Watching You*, CBA REC., Sept. 1994, at 18, 18-19.

168. See *id.* at 18-20.

169. See *id.*

170. See 735 ILL. COMP. STAT. 5/15-1107 (2009).

171. *Koehler v. First Nat’l Bank of Louisville*, 597 N.E.2d 1261, 1264 (Ill. App. Ct. 1992).

172. *Id.* Bank customers sued based on an implied duty of good faith, claiming that the bank had breached this duty when it would not close a loan with the customers based on a rate quoted in a commitment memo. *Id.* at 1262-63.

173. *Carrico v. Delp*, 490 N.E.2d 972, 976 (Ill. App. Ct. 1986).

174. *Id.*

not unconscionable and should be allowed.<sup>175</sup> Without an unconscionable act, the court has no reason or way to deny the use of the acceleration clause, even if others would consider the lender unduly harsh to actually impose it.<sup>176</sup>

In *Luxonomy Cars, Inc. v Citibank, N.A.*, the New York Supreme Court, Appellate Division, held there was an implied duty of good faith in a bank's implementation of an acceleration clause.<sup>177</sup> Generally, New York courts will allow the enforcement of an acceleration clause for breach by nonpayment or nonpayment of interest.<sup>178</sup> However, when another provision in the loan agreement is breached, "New York courts will not allow foreclosure unless the mortgagee can show his security has been impaired."<sup>179</sup> The idea behind this provision is that the courts are not willing to enforce a harsh penalty on a borrower for an insignificant breach of the agreement, but the courts have not explicitly explained what would qualify as a security impairment.<sup>180</sup> On the other hand, the courts are not willing to impose a duty of good faith that "would be inconsistent with other terms of the contractual relationship."<sup>181</sup> They recognize that there is a limit to the implied duty of good faith.<sup>182</sup>

## 6. California

In California, contracts contain an implied duty of good faith.<sup>183</sup> The courts recognize that this implied duty is especially important when one party has a discretionary power that affects the rights of the other party.<sup>184</sup> The basis behind this view is that both parties should "refrain from doing anything [that] will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract."<sup>185</sup> This type of reasoning was central to the United States District Court's holding in *Celador Interna-*

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175. *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 885 (N.Y. 1930).

176. *Id.*

177. 408 N.Y.S.2d 951, 953-54 (App. Div. 1978). The court held that although there was an implied duty of good faith in this instance, the bank did not breach that duty. *Id.* at 954.

178. Michael Giusto, *Mortgage Foreclosure for Secondary Breaches: A Practitioner's Guide to Defining "Security Impairment,"* 26 CARDOZO L. REV. 2563, 2564 (2005).

179. *Id.*

180. *Id.*

181. Henkel, *supra* note 157 (citing *Emigrant Mortg. Co. v. Chi. Fin. Servs., Inc.*, 898 N.E.2d 1069 (Ill. App. Ct. 2007) (applying New York law)).

182. *See id.*

183. *Id.* (citing *Mangindin v. Wash. Mut. Bank*, 637 F. Supp. 2d 700 (N.D. Cal. 2009) (applying California law)).

184. *Id.* (citing *Shahani v. United Commercial Bank*, 457 B.R. 775 (N.D. Cal. 2011) (applying California law)).

185. *Id.* (citing *Mangindin*, 637 F. Supp. 2d 700 (applying California law)).

*tional Ltd. v. Walt Disney Co.*<sup>186</sup> The court held that a breach of the implied duty of good faith involves “a conscious and deliberate act that ‘unfairly frustrates the agreed common purposes and disappoints the reasonable expectations of the other party.’”<sup>187</sup>

### 7. Nevada

Nevada is one of the states that has struggled the most with commercial foreclosures.<sup>188</sup> As of October 2009, it was ranked third out of all states for commercial real estate delinquencies.<sup>189</sup> In April 2009, Las Vegas was ranked third in the United States for troubled commercial properties.<sup>190</sup> Nevada defines a commercial mortgage loan as one that, “[d]irectly or indirectly, is secured by a lien on commercial property” and “[i]s created with the consent of the owner of the commercial property.”<sup>191</sup> In *A.C. Shaw Construction, Inc.*, the Supreme Court of Nevada held that there is an implied duty of good faith in all contracts.<sup>192</sup> It noted especially that the implied duty was particularly relevant in regard to the term of the contract that allowed one party to use its discretion.<sup>193</sup>

### 8. Arizona

Arizona is another state that has been devastated by the economic downturn.<sup>194</sup> Phoenix, in particular, has been hit hard because of “rampant overbuilding, a national economic crisis, spiking unemployment and a near halt in population growth.”<sup>195</sup> In this area, lenders have begun to issue fore-

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186. 347 F. Supp. 2d 846, 852 (C.D. Cal. 2004). Plaintiffs, TV Producers, sued their broadcasting companies alleging a breach of the duty of good faith based on a number of actions taken by the broadcasting companies. *Id.* at 850-51.

187. *Id.* at 852 (quoting *Careau & Co. v. Sec. Pac. Bus. Credit*, 272 Cal. Rptr. 387, 400 (Ct. App. 1990)).

188. Steve Green, *Nevada Ranks Third in Rate of Delinquent Commercial Loans*, LAS VEGAS SUN, Oct. 14, 2009, <http://www.lasvegassun.com/news/2009/oct/14/nevada-ranks-third-rate-delinquent-commercial-loan/>.

189. *Id.*

190. Lucht & Wargo, *supra* note 136 (ranking New York and Los Angeles ahead of Las Vegas for the number of troubled commercial properties).

191. NEV. REV. STAT. § 645E.030 (2010).

192. *A.C. Shaw Constr., Inc. v. Washoe Cnty.*, 784 P.2d 9, 9 (Nev. 1989).

193. *Id.* at 11 (noting that one party was able to “terminate the contract at its convenience”).

194. See Matthew N. Murray, *Resolving Arizona’s Budget Mess: Do It Right, and the State Wins; Do It Wrong, and We’ll Suffer for Generations*, ARIZ. REPUBLIC, Jan. 8, 2011, <http://www.azcentral.com/arizonarepublic/viewpoints/articles/2011/01/08/20110108arizona-budget-murray.html>.

195. Rudolf, *supra* note 3; see J. Craig Anderson, *Arizona Commercial Real Estate Brokers: Some Lenders Ignore Crisis*, ARIZ. REPUBLIC, May 30, 2010, <http://www.azcentral.com/arizonarepublic/viewpoints/articles/2010/05/30/20100530arizona-commercial-real-estate-brokers-some-lenders-ignore-crisis.html>.

closures notices on many commercial properties.<sup>196</sup> Over the past decade, the foreclosure rate was “practically zero.”<sup>197</sup> This increase in foreclosure notices is due primarily to the decrease in property values.<sup>198</sup> This area epitomizes the issue of lenders applying insecurity clauses based on decreases in property value in an area where the overall market has significantly declined.

Arizona courts have implied a duty of good faith in a number of scenarios. In *Richter v. Dairy Queen of Southern Arizona, Inc.*, the Court of Appeals of Arizona held that a franchisor had to exercise in good faith its discretion over withholding consent.<sup>199</sup> A year later, this court once again held that there is an implied duty of good faith in contracts.<sup>200</sup> This court expanded its interpretation to include “[s]ubterfuges and evasions” as violations of the implied duty of good faith.<sup>201</sup> Additionally, the Supreme Court of Arizona has implied a duty of good faith in many instances.<sup>202</sup>

#### B. Attempts at Establishing Uniformity Among the Nation in Addressing Bad Faith in Insecurity Clauses

The American Law Institute created the Restatement (Third) of Property (Mortgages) in 1997 to create uniformity in a range of mortgage law

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com/business/articles/2010/05/30/20100530biz-arizona-commercial-real-estate-market-lenders.html.

196. J. Craig Anderson, *Lenders Increase Efforts on Bad Loans: With Delinquencies Up on Commercial Property, Use of Notes on the Rise*, ARIZ. REPUBLIC, Aug. 29, 2010, <http://www.azcentral.com/12news/news/articles/2010/08/29/20100829biz-lenders-increase-efforts-bad-loans0829.html>.

197. J. Craig Anderson, *Commercial Foreclosures Rocket: Valley Is 'at the Tip of the Iceberg' for Notices, Expert Says*, ARIZ. REPUBLIC, Aug. 5, 2009, <http://www.azcentral.com/arizonarepublic/business/articles/2009/08/05/20090805biz-commercialforeclosures0805.html>.

198. *Id.*

199. 643 P.2d 508, 509 (Ariz. Ct. App. 1982). Franchisees argued that the franchisor unreasonably withheld its consent. *Id.*

200. *Diagnostic Lab., Inc. v. PBL Consultants*, 666 P.2d 515, 519 (Ariz. Ct. App. 1983). Two doctors worked at a laboratory and at a medical center. *Id.* at 517. They signed a non-competition agreement with the laboratory, which the doctor's current work at the Medical Center did not violate. *Id.* at 517-18. However, a few years later, the Medical Center expanded its services, which put it in competition with the laboratory. *Id.* at 518.

201. *Id.* at 519 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981)).

202. *See Enyart v. Transamerica Ins. Co.*, 985 P.2d 556, 558, 561 (Ariz. Ct. App. 1998) (noting that the insurer failed to purchase a back-up annuity as part of a settlement agreement); *Wells Fargo Bank v. Ariz. Laborers, Teamsters & Cement Masons Local No. 395 Pension Trust Fund*, 38 P.3d 12, 17-18, 28 (Ariz. 2002) (noting that the interim financier provided information to permanent financier regarding borrower).



topics.<sup>203</sup> This Restatement states that a lender's bad faith is a defense to the use of an acceleration clause.<sup>204</sup> Although the Restatement provides some guidance on the use of insecurity clauses, particularly not allowing these clauses to be used if the mortgagee has acted in bad faith,<sup>205</sup> it has not been successful in establishing uniformity among the states. State courts can adopt provisions of the Restatement if they address a particular issue in litigation that is discussed in the Restatement.<sup>206</sup>

Although this Restatement has addressed the issue of bad faith in acceleration clauses, it has not specifically addressed a lender's implied duty to act in good faith when using an insecurity clause. The Restatement does not go into enough detail in the arena of good faith in commercial mortgage insecurity clauses. There needs to be a more comprehensive and specific approach to the treatment of good faith in the application of these clauses.

### III. PROPOSAL OF A UNIFORM STANDARD FOR DETERMINING WHEN A LENDER ACTS IN BAD FAITH IN THE USE OF AN INSECURITY CLAUSE

There should be a uniform standard established by courts to determine if a lender has breached an implied duty of good faith when ordering a re-appraisal of collateral, applying an insecurity clause, and ultimately, calling a loan or foreclosing. The various state court jurisdictions should adopt this type of standard to protect borrowers from lenders that exercise their discretion in bad faith. If a borrower has not violated any material covenants of the loan and the appraised value of the collateral is greater than the outstanding balance currently due on the loan, then the courts should find that a lender has breached an implied duty of good faith if it uses an insecurity clause in this scenario, without other compelling evidence.

#### A. Proposed Standard in Its Entirety

Assuming that the borrower has not violated any material covenants of the loan and the appraised value of the collateral is higher than the remaining balance due on the loan, the lender should not be able to take advantage of the insecurity clause without other evidence of insecurity. Despite the decrease in the appraised value of the property, if a lender can still recover the outstanding balance due on the loan from the borrower's payment and

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203. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES (1997); *see also* Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1407 (2004).

204. *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 8.1 (1997).

205. *See id.*

206. Nelson & Whitman, *supra* note 203, at 1409.

collateral, then the lender is not insecure.<sup>207</sup> Under these circumstances, a lender should be deemed to have acted in bad faith if it executes an insecurity clause. The lender is not insecure—it still has two avenues of collection for its loan: the regular payments from the borrower and the collateral.<sup>208</sup>

Because an appraisal is ultimately just an estimate of a property's value, a lender should not be allowed to use solely this valuation to call a loan when the borrower has done nothing else to suggest that future payments will not be made.<sup>209</sup> There are times when regulators require banks to reappraise their collateral, and it could be during this process that a lender discovers that a particular property has significantly decreased in value, suggesting insecurity.<sup>210</sup> However, if the lender chooses to have a property reappraised when regulation does not require it to, then it may be an arbitrary choice by the lender. There may be some instances where a lender would be justified in obtaining a reappraisal, but an overall downturn in the real estate market should not be justification for a lender to target a specific property for reevaluation.<sup>211</sup> If a lender is genuinely concerned that the value of its collateral is no longer an adequate secondary source of repayment, then the lender should have the property reappraised. However, frequently this genuine concern is not the only motivation. Rather than having only a concern that a specific property has decreased in value to a level that is impairing their loans, lenders are using the poor market conditions as an excuse to accelerate loans and gain liquidity in order to deal with their own problems.<sup>212</sup> Lenders should not be able to take advantage of responsible borrowers who are making their payments just because the overall market has declined or is struggling.<sup>213</sup> The courts must introduce a standard for determining when lenders are acting in bad faith by implementing an insecurity clause. Therefore, courts should adopt the following two-prong analysis to determine a breach of the implied duty of good faith by lenders implementing insecurity clauses in commercial mortgages.

### 1. *The Borrower Has Not Violated a Material Covenant of the Loan*

If the borrower has not violated a material covenant of the loan, then the lender must be able to show other evidence to prove that it is insecure.

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207. See discussion *supra* Section I.A.

208. See *supra* note 7.

209. See discussion *supra* Subsection I.C.1.

210. See discussion *supra* Subsection I.C.2.

211. See discussion *supra* Section I.A. Perhaps if a borrower made a substantial structural change to the secured property or if there was a fire that damaged the property, then the lender may be justified in having the property reappraised to see if the value of the property was sufficient to act as a secondary avenue of recovery.

212. See discussion *supra* Part I.

213. See discussion *supra* Section I.A.

Two major covenants in commercial mortgage agreements are that there is not a monetary default by the borrower and that the borrower has maintained the collateral in a condition consistent with the original loan terms.<sup>214</sup> If the borrower violates one of these covenants, or another similar covenant, then that could be enough to suggest that the lender is in good faith insecure.

To avoid a monetary default, the borrower must make regular timely payments towards the loan, as agreed to in the terms of the loan.<sup>215</sup> Although collateral secures a commercial mortgage, the primary avenue of collection for the lender remains the borrower's regular loan payments. If the borrower has been making payments as required and has always paid in the timeframe outlined in the agreement, then the lender generally would have no reason to feel insecure. The lender should have to show some other reason why it feels insecure. The primary purpose of an insecurity clause is to protect the lender in instances when it believes it will not be able to recover all the money due on the loan.<sup>216</sup> If the borrower is paying the lender as arranged, then the lender is receiving what it is entitled to.

It is possible that the borrower could be making payments and the lender could still feel insecure. If the borrower has been making consistently late payments, then these late payments could give the lender a good faith reason to believe that it is insecure and may not receive future payments.<sup>217</sup> Tardiness could suggest to the lender that the borrower may be having difficulty coming up with monthly payments, which could make the lender feel insecure about repayment in the future. In addition, if the lender has been making payments, but the lender knows that the borrower has not been paying any of its other bills or has overdrawn its bank account, then this may suggest insecurity to the lender.

If the borrower has taken steps to maintain the collateral as required by the loan agreement, then the courts should take this maintenance into consideration when determining the lender's insecurity. All collateral is subject to normal wear and tear, but this deterioration does not necessarily mean the value of the collateral has significantly decreased.<sup>218</sup> In the original loan agreement, the lender bargained for the collateral to be of a particular quality, based on the appraisal at the origination of the loan. If the borrower has maintained the condition of the collateral, then the collateral likely still

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214. For other examples, see *What to Expect When Applying for a Commercial Mortgage Loan: Banks and Private Alternatives*, REALSTATEABC.COM, <http://www.realestateabc.com/loanguide/applying-commercial2.htm> (last visited Apr. 19, 2012).

215. See *supra* note 4.

216. See discussion *supra* Section I.A.

217. For a similar example, see BLACK'S LAW DICTIONARY, *supra* note 1, at 866 (stating that a creditor can demand payment if "the debtor suddenly loses a significant source of income").

218. See *supra* note 5.

exists at the bargained for quality. This situation is different from a situation where there is a decrease in the appraised value.<sup>219</sup> If the collateral exists in the same condition as the original loan agreement required, then the lender should have to show more evidence than just a decrease in appraised value to show insecurity.

If the real estate market is stable but a particular property has deteriorated because of the borrower's inaction, then this deterioration may suggest insecurity. At all times during the loan agreement, the collateral is supposed to act as a second avenue of recovery if needed.<sup>220</sup> The deterioration of the collateral could affect the lender's ability to be made whole if the lender needed to foreclose on the property to recover.

*2. The Value of the Collateral, Although Reduced from the Original Value of the Loan, is Greater Than the Outstanding Balance Due on the Loan*

When determining if a lender breached an implied duty of good faith in its application of an insecurity clause, courts should consider whether the appraised value of the collateral is greater than the outstanding balance due on the loan. This relationship between the appraised value and the outstanding balance due should be taken into consideration because of the extremely subjective nature of appraisals.<sup>221</sup> There are a number of factors that go into a typical appraisal, such as market area, neighborhood, size, and improvements.<sup>222</sup> In the current market, there are less sales going on, so it is difficult for appraisers to find comparable properties to use in their estimation of the property's value.<sup>223</sup> In addition, it is difficult to find accurate appraisals in today's market because many of the sales that are being made are often distressed sales.<sup>224</sup> These factors can greatly affect an appraisal and should be considered when determining a lender's insecurity.<sup>225</sup>

Courts should assess whether, at its current appraised value, the collateral can still adequately serve as a second avenue of recovery for the lender if the borrower stops making payments.<sup>226</sup> If the appraised value of the property is greater than the outstanding balance due on the loan, then the lender should not be able to claim insecurity based solely on the appraised value because the collateral would make the lender whole. If the borrower

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219. See discussion *supra* Section I.C.

220. See *supra* notes 6, 7 and accompanying text.

221. See discussion *supra* Subsection I.C.1.

222. See discussion *supra* Subsection I.C.1.

223. Billingsley, *supra* note 13, at 4; see also *Examining the Continuing Crisis*, *supra* note 88, at 169 (explaining that there are less sales).

224. See *Examining the Continuing Crisis*, *supra* note 88, at 169.

225. See discussion *supra* Subsection I.C.1.

226. See *supra* notes 6, 7 and accompanying text.

stops making payments, the lender would still be able to recover the money it is due by foreclosing on the secured property and selling it.<sup>227</sup> Courts should consider, on a case-by-case basis, whether there is a reasonable prospect that the lender would be made whole by the foreclosure of the collateral. If so, the court should find that the lender has breached its implied duty to use the clause in good faith.

Many markets in the United States have been hit very hard by the current commercial real estate downturn.<sup>228</sup> However, there are companies in these areas that are still profitable and are not struggling to make their loan payments.<sup>229</sup> Because of the overall downturn in their areas, it is possible that the appraised values of their properties have decreased despite their continued success.<sup>230</sup> It is important to protect the loans of these borrowers who are facing decreased property values because of the overall market, but who are still capable of making their loan payments.<sup>231</sup> By considering whether the property value is greater than the outstanding loan balance, the courts would create a compromise between lenders wanting to guarantee repayment and borrowers whose properties have decreased in value only because of the surrounding market. If collateral is reappraised at a lower value than it was originally appraised for, but the lender will still be made whole by foreclosure of the property, then the lender should not be considered insecure based on this decrease in value alone.

If a borrower's outstanding loan balance is \$50,000, and the real estate market in that area is declining, then the lender may choose to have its collateral reappraised. If the collateral was originally valued at \$200,000, the same amount as the original mortgage, and is reappraised at \$100,000, then the lender may try to argue that it is insecure. In reality, the collateral is more than sufficient security to protect the lender's interest because the value of the collateral exceeds the outstanding loan balance. Therefore, the decrease in the appraised value alone should not be enough to show that the lender is insecure.

When determining if the value of collateral is greater than the balance outstanding on the loan, the courts should take into consideration expenses that will be required to dispose of the collateral and the likelihood that the value will continue to decline. If a property has decreased in value, the

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227. See *supra* note 7.

228. See discussion *supra* Part I.

229. See *supra* note 3.

230. See *supra* note 3.

231. "The congressmen are calling for the agencies to make clear public statements encouraging lenders to continue to make credit available for performing assets, even if the value of the property has taken a hit in its value." Cyrus Sanati, *Congress Worries About Commercial Real Estate*, N.Y. TIMES, Feb. 1, 2010, <http://dealbook.nytimes.com/2010/02/01/congress-worries-about-commercial-real-estate/?scp=1&sq=commercial%20foreclosure&st=cse>.

lender may still reasonably feel insecure if property values are still significantly decreasing or if the property will be very expensive to dispose of. For example, if the value has decreased to \$100,000, but it will cost \$75,000 to dispose of the property, then the lender would be insecure because the foreclosure would not make the lender whole.

Although these factors deserve consideration when determining whether a lender breached a duty of good faith in its use of an insecurity clause, it is important to remember that an appraisal is at best an educated guess of a property's value, and lenders should not be permitted to use an appraisal estimate offensively to trigger an insecurity clause.<sup>232</sup> Where the lender's basis for insecurity is the appraised collateral value, the borrower should be able to rebut this value. Courts should recognize that, as a market declines, appraisals become more of an estimate and less of a comparison of similar properties.<sup>233</sup> If the current value of the collateral is greater than the outstanding balance due on a loan, then the court should require the lender to show other evidence of insecurity.

#### B. Applying the Proposed Standard in Today's Market

In areas where the economic downturn has greatly affected the community, many borrowers have maintained profitable businesses and have made their payments as stipulated by their loan agreements.<sup>234</sup> If the basis for the lender's insecurity claim is a decrease in the appraised value, the courts should limit this claim by a duty to act in good faith. If the borrower has done nothing to suggest that it is insecure, it should not be forced to pay the full amount of the loan earlier than arranged. In many instances, the borrower is following the same practices it was doing during the prior repayment period under the loan. It has not changed its behavior to suggest an inability to pay, yet it is being treated as if, suddenly, it will be unable to pay. Although the value of the collateral has decreased, the court should evaluate whether there is actually a concern that the lender will not be able to fully recover under the agreement.<sup>235</sup>

The lender should not be able to use the appraisal process to create a default in a situation where the overall market has significantly decreased.<sup>236</sup> In such a total market meltdown, when there has not otherwise been a default in the loan and the appraised value is still greater than the outstanding balance due on the loan, using an insecurity clause based on an appraised valuation would not seem to be what the parties bargained for when they

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232. See discussion *supra* Subsection I.C.1.

233. See discussion *supra* Subsection I.C.1.

234. See *supra* note 3.

235. See discussion *supra* Section I.A.

236. See discussion *supra* Section I.A.

included the insecurity clause in their agreement.<sup>237</sup> The insecurity clause allows the lender to protect itself from nonpayment.<sup>238</sup> Using this clause to accelerate the loan for any reason other than the risk of non-payment should be considered a breach of the duty of good faith.<sup>239</sup> The lender cannot use the clause to get something that it gave up in negotiations.<sup>240</sup> The lender made the loan for a period of time and should not be able to accelerate payment simply because the market has taken a turn for the worse.<sup>241</sup>

If the borrower has not violated any material covenants of the loan agreement, then the lender should have to show more than simply a decrease in appraised value in order to justify insecurity. There are instances where all of these conditions are met, but the court could still find that the lender did not act in bad faith. However, in these instances, the lender would have to show something beyond simply a decrease in appraised value. For example, if the lender knew that the borrower, although making its monthly loan payments, was not paying its other bills, this could suggest that the borrower may eventually have difficulty paying the lender as well. Or, if the business was losing money, this loss may suggest that in the future the borrower would be unable to make its loan payments. Another example would be if the borrower had overdrawn its bank account. These types of situations may provide enough support for a lender to show that it is insecure. However, if the borrower has not violated any material covenants in the loan agreement and the lender cannot show any reasons for its insecurity beyond the decrease in appraised value, then the court should hold that the lender breached its implied duty to act in good faith.

### CONCLUSION

An implied duty of good faith should limit the application of insecurity clauses in commercial mortgages. Although insecurity clauses play an important role in protecting lenders, this protection should not be without boundaries. Establishing standards by which courts could evaluate lenders' actions to determine if they acted in bad faith when applying an insecurity clause would allow lenders to have the benefits of these clauses, while also protecting borrowers. There needs to be a balance between the two competing objectives.

When an overall market has downturned significantly, a lender should have to prove its insecurity by showing more than a decrease in the value of collateral. Courts should evaluate whether a borrower has violated any cov-

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237. See discussion *supra* Section I.B.

238. See discussion *supra* Section I.A.

239. See discussion *supra* Section I.B.

240. See discussion *supra* Section I.B.

241. See discussion *supra* Section I.B.

enants in the loan agreement and whether the current value of the secured property is greater than the outstanding balance due on the loan. If the borrower has not broken any material covenants in the loan and the appraised value of the collateral is greater than the outstanding balance of the loan, then the court should require the lender to show other evidence of its insecurity. If the lender cannot, then the court should hold that the lender breached an implied duty of good faith when it implemented the insecurity clause. This standard would alleviate many of the problems associated with insecurity clauses implemented during an economic downturn.